Yannis Stournaras: Greek economy - current developments

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Belgian Business Club (BBC), Athens, 5 September 2019.

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A. General outlook and developments in the real economy

The Greek economy continues тo recover, although with relatively moderate growth rates due to the global slowdown. Economic sentiment has increased to multiyear highs, bank funding and liquidity conditions have improved, property prices started to increase and bond yields have declined significantly in recent months, particularly following the May European Parliament elections and the July national elections. Confidence in the banking sector has improved substantially and capital controls were fully lifted on September 1st.

he new government has been elected on a reform agenda and a platform of business-friendly economic policies with a focus on attracting investment, particularly foreign direct investment, by improving the investment climate, accelerating reforms, speeding up privatizations, unfreezing large investment projects and reducing taxation, while at the same time maintaining fiscal discipline and the agreed fiscal targets. Short-term economic indicators suggest that the economy shows significant resilience to the global slowdown. This is due to the strengthening of domestic demand as the economy emerges from a long-lasting recession, which, to a large extent, counterbalances the negative effect from the global slowdown.

In particular:

– Economic sentiment of both consumers and businesses has reached a twelve-year high. Consumer confidence is at its highest level since September 2000.

- PMI remains firmly above the threshold of 50 for twenty-seven months in a row, suggesting robust growth in the industrial sector.

- The recovery in the labour market continues for the fifth year, with net inflows of new jobs in the private sector exceeding 280 thousand in the first eight months of the year.

- Revenues from tourism in real terms increased at double-digit numbers during the first six months of the year despite a slight decline in tourist arrivals compared to last year, suggesting a geographic rebalancing of tourist arrivals from countries with relatively higher per capita income compared to previous years.

- In the external sector, exports of goods decelerated slightly in the first six months of the year, driven by the decrease in oil exports, while exports of all other goods registered positive growth rates. Exports of services continued to grow strongly with an improvement in both the travel and the transport balances.

- Second quarter 2019 data suggest that the recovery of the Greek economy continues with a growth rate of 1.9%, while GDP in the first semester of 2019 grew by 1.5%. The main drivers of GDP growth in Q2 were net exports and public consumption. According to forecasts by the Bank of Greece, economic activity is projected to increase by 2.3% in the second semester of 2019 and by 1.9% in the year as whole.

Financial indicators have also improved substantially, suggesting increased confidence in the prospects of the Greek economy.

In particular:

– Government bond yields have declined sharply since the start of the year. For example, 10-year yields came down to 1.56% at the end of August from nearly 4.5% in the beginning of January 2019.

- Deposit inflows have continued. €12.3 billion of domestic private deposits have returned to banks since the start of 2018.

- Bank credit to non-financial corporations recorded an annual rate of growth of 2.9% in July 2019, which is the highest rate since mid-2010.

- House prices have increased for six quarters in a row after suffering significant declines since the start of the crisis.

Nevertheless, Greece faces a number of challenges looking forward:

- Given the country's poor demographic outlook and tight budget constraints, achieving economic growth significantly higher than the current levels of 2% in the long term is a demanding task and requires structural reforms to boost productivity as well as investment, in particular foreign direct investment.

- Tackling the problem of non-performing loans, which still represent 43.6% of total loans, is critical to the health of the banking system and to its ability to finance investment and support the real economy.

In order to contain future risks and address the remaining challenges and crisis legacies, the government must quickly implement its business-friendly reform agenda it was elected to. Moreover, the continuation of reforms is an obligation to which Greece is bound in the context of enhanced surveillance as well as a precondition for the activation of the medium-term debt relief measures. Strengthening the credibility of economic policy through the implementation of reforms, the speeding up of privatizations, and the unblocking of already approved investment plans will increase market confidence in the growth prospects of the Greek economy.

B. Non-performing loans (NPLs) and developments in the banking sector

With about €75 billion in non-performing loans (NPLs) as of mid-2019, equivalent to 43.6% of all loans, Greece remains a crucial testing ground for the strategy of "risk reduction" in the euro area. Although economic activity resumed in 2017, higher and sustainable growth rates require the end of banks' deleveraging. This will need to be backed by a comprehensive transfer of bad loans from bank balance sheets, combined with private debt restructuring.

The high ratio of NPLs in Greek banks has been an early and highly visible effect of the financial and economic crisis in the country. Over the past three years to mid-2019, the absolute stock of NPLs fell by about €30 billion, largely through write-offs and sales. Moreover, several reforms have also enhanced the framework for private debt resolution:

• acceleration of the sale by banks of collateral in defaulted loans through electronic auctions;

• simplification of the sale of NPLs through the liberalisation of the loan-servicing regime and the introduction of a secondary loan market;

• an out-of-court debt restructuring framework, which also included a write-down of tax arrears, though only a few cases up to now have been concluded under this procedure;

• a reform of the insolvency regime for households and enterprises.

Ambitious targets for NPL reduction have been agreed between the four largest banks and the ECB/SSM, and under a similar framework by the Bank of Greece for smaller banks. NPL ratios are to fall to 35% by the end of this year, and close to 20% by the end of 2021. It should be noted however that even if these targets are met, Greek banks will have more than five times higher NPL ratios that the EU average.

In this regard, it is important that a truly systemic solution, resembling an Asset Management Company, is implemented in order to complement the individual efforts of each bank to swiftly improve asset quality. Greece has been dealing with asset quality issues for many years and now it is the time to speed up efforts in order to approach EU averages within a reasonable amount of time. Over the next few months, adequate instruments should be established for an orderly and swift debt resolution, while the European Commission should provide the necessary authorisation without undue delays, taking into account the probability of external, worldwide downside risks. It should be reminded that all Member States under financial stress have made use of similar systemic solutions, in the form of Asset Management Companies.

Greek banks have maintained satisfactory capital adequacy ratios and this has been extremely significant for financial stability considerations. Going forward, it will be up to each individual bank and their equity-holders to assess their business models and growth prospects.

At present, legacy NPLs impose a major constraint upon Greek banks' profitability. In particular, first half 2019 results produce a Return on Equity (RoE) for systemic banks of only 2.1%, despite the satisfactory increase of pre-provisioning income compared to the same period last year.

Net interest margin declined to 2.2% in the first half of 2019, compared to 2.4% in the same period of 2018, while the cost of risk continues to be close to 2%. These trends indicate that unless NPLs are removed from bank balance sheets very quickly, Greek banks will not be able to generate enough capital internally. Moreover, such a high level of NPLs blocks Greek banks from extending much needed credit to the real economy. As already mentioned, rapid growth cannot be achieved unless the banking sector can finance investment at an adequate level and at a reasonable cost. A substantial reduction of NPLs will lead to improved rating scores for the banks, thus allowing access to private funding at a lower cost, which translates to lower interest rates for the borrowing entrepreneur.

Although sales, primarily through securitizations, and loan write-offs are the main drivers of NPL reduction, this should not lead banks to relax their efforts to successfully restructure the loans that are still in their portfolios. On this front, progress is rather slow and the Bank of Greece in cooperation with the SSM will increase pressure to improve the performance of long-term loan modifications so that the observed high rate of redefault is contained.

Foreclosed real estate assets, obtained by the banks via auctions or otherwise, is another challenge but also an opportunity. Currently they amount to €2.3 billion and are expected to rise as the real estate market improves. Such assets may lead to significant capital gains for the banks.

More work is needed to further improve the regulatory framework so as to remove bureaucratic obstacles and legal loop holes that delay the utilization of the recently established policies. The new regime of primary residence protection must fit into a single and permanent legal framework for the insolvency of physical persons, while the out-of-court work out regime must be radically reviewed.

High expectations have also been created with respect to the performance of the newly developed NPL servicing market. It is still too early to draw conclusions, but the Bank of Greece will closely monitor the results achieved by independent servicers, in order to ensure that there is real value added for banks and the economy as a whole.

The liquidity conditions of the Greek banking system have substantially improved, as reflected in the elimination of ELA (as of March 2019) and the overall, significant reduction in total central bank funding (at end August it stood at €8.2 billion). The decrease in central bank financing is a result of the following positive developments:

First, domestic private sector deposits have been on a constant upward path since their lows in May 2016, registering at the end of July a cumulative increase of around €24 billion and reaching their highest level since February 2015. Deposits are expected to continue increasing steadily, reflecting positive developments in terms of economic growth and confidence in the stability of the financial system.

Second, Greek banks have improved considerably their access to the interbank market and have increased their funding from other sources (issuance of debt securities, loan-sales and securitization). Specifically, Greek banks have increased their funding from the secured market under improved terms, against an expanded set of international counterparties and collateral. Moreover, they have returned to the capital markets with the successful placement of, initially, covered bonds starting in late-2017. In 2019 further positive steps have been made, including issuances of Tier II bonds, aiming to improve their capital.

Another positive factor for the banks, was the considerable increase of the available eligible collateral for ECB monetary policy operations, following the upgrade of Greek banks' covered bond programmes to investment grade. It is noteworthy that for the first time since 2012, all Greek covered bond issuers have investment grade rated programmes.

Last, but not least, the valuation of assets held by the banks increased considerably. Most prominently, as it has already been said, Greek government bonds exhibited an outstanding performance throughout 2019, with the 10-year bond yield reaching the historical low of 1.56% at the end of August. Positive sentiment has also been reflected in the Athens Stock Exchange price index, which briefly rose above 900, the highest since March 2015, before correcting to 868 at the end of August, an increase close to 45% in 2019.

The sustained progress in the liquidity conditions was a contributing factor to the recent abolition of capital controls. This positive development, in conjunction, inter alia, with the reduction of NPLs, is expected to trigger further upgrades in the rating of the banks, along with the expected upgrades in the rating of the sovereign. In turn, this would support their efforts to further improve their liquidity and, in line with the decrease in the sovereign's cost of funding, to issue unsecured bonds. Against this background, one can be confident that the liquidity of the Greek banking system will be further strengthened in the coming months.

C. Fiscal developments in 2019 and projections

The legislation of an expansionary fiscal package in May 2019 put at stake the attainment of the primary surplus target of 3.5% of GDP agreed in the context of the enhanced surveillance. According to Bank of Greece estimates, with end of June fiscal data, a fiscal gap of about 0.6% of GDP was projected for 2019.

This development necessitated an adjustment of expenditure in order to fulfill the fiscal targets in the context of the enhanced surveillance. Indeed, latest (August) cash fiscal data indicate, according to the Bank of Greece, that the 2019 fiscal target will be met. This outcome is driven by adjustment of expenditure as well as by revenue over-performance (mainly VAT) in the last two summer months.

However, fiscal risks are tilted to the downside and mainly relate to the yield of the latest instalment scheme. Another downside risk relates to the pending court decisions reversing past pension cuts. This would entail a one-off expenditure in retroactive payments. There is, furthermore, an additional risk of a permanent increase in expenditure on a yearly basis in case the Council of State rules that the provisions of the 2016 pension reform are unconstitutional too. Although the latter decision is expected by October, any development is unlikely to affect the

2019 budget year.

The general government debt is projected to decline, driven mainly by primary surpluses, and a favourable interest-growth rate differential. The debt sustainability analysis of the Bank of Greece shows that the debt relief measures agreed by the Eurogroup on 21 June 2018 considerably improve debt sustainability in the medium term, but risks remain elevated beyond the early 2030s.

Further revenue gains could be generated from wider use of non-cash transactions. Bank of Greece research estimates that an increase by one percentage point in the share of private consumption spent through payment cards increases VAT revenue by 1% through increased compliance. The gradual relaxation of cash restrictions experienced so far does not appear to be reversing the use of cards, albeit the increase in the share of consumption spent through cards appears to have halted.

Another challenge to be faced is related to the revenue-heavy fiscal mix. The Bank of Greece has repeatedly stressed the need to shift the current fiscal policy mix away from distortionary taxation, with a view to making fiscal policy more growth-friendly and sustainable. For example, in the latest Monetary Policy Report (July 2019), research carried out at the Bank of Greece showed that a lower tax burden on labour income can generate considerable permanent gains in economic activity. Furthermore, a lower tax burden on labour could become self-financed already in the medium term, if combined with fiscal structural reforms that improve tax compliance.

It is a positive development that the government stated, right from the beginning of its term, that it will respect the agreed fiscal targets. At the same time, and as the Bank of Greece has been arguing for a number of years, the government is negotiating with the institutions a reduction, directly or indirectly, of the primary surplus target.

A lower, more realistic, primary surplus target compared to the current one of 3.5% of GDP through 2022, if combined with more reforms and privatisations, would very probably imply lower, rather than higher public debt. This is so because, with a public debt-to-GDP ratio of 180%, a one percentage point-higher growth rate (likely to mateliarise if the lower primary surplus target is achieved through lower taxes and social contributions, combined with more privatisations and reforms) and/or 100 basis points-lower borrowing costs (already materialised, relative to the European Commission’s baseline scenario) are 1.8 times more effective in reducing the debt ratio than an additional GDP percentage point of primary surplus.

The fact that borrowing rates today are much lower than under the baseline scenario in the European Commission’s debt sustainability analysis provides leeway for easing the fiscal targets without compromising debt sustainability. Moreover, the Stability and Growth Pact allows for fiscal flexibility so long as additional reforms increase potential growth.

Overall, there are plenty of arguments in favour of lower primary surplus targets and ample room for a compromise solution. In such a solution, primary surpluses could be lowered in exchange for an acceleration of reforms; the outcome will be a win-win situation for both Greece and its EU partners, given that Greece will be able to return faster to a high growth path that safeguards fiscal sustainability and the repayment of bail-out funds. Downside risks related to external, worldwide factors also justify the reduction of the primary surplus fiscal target. In this context, Christine Lagarde’s comments yesterday in the European Parliament arguing for a lower primary surplus in Greece are fully justified.

D. Conclusions

The above mentioned economic developments along with the recent elimination of capital controls, are expected to facilitate the reinstatement of Greek government bonds to investment grade status soon, which will pave the way for their inclusion in the ECB’s Asset Purchase

Programme. This, in turn, will further lower borrowing costs for the Greek economy, thereby boosting growth and improving debt sustainability. In such a benign scenario, higher growth rates than currently projected, that is a growth rate close to 3%, could be achieved through increased investment, taking also into account the still negative output gap.

Having said all the above, Greece at the moment has a narrow window of opportunity given the global conditions of still positive growth rates and the current low interest rate environment. The government should proceed with its reform programme as quickly as possible to deal with the medium and long-term risks of the Greek economy and address challenges such as low productivity growth, demographic trends and low investment, as these favourite conditions might be reversed anytime in the future, given the downside risks in the world economy.